Office of Chief Counsel
Internal Revenue Service

memorandum

CC:[redacted]:TL-N-1391-00
[redacted]

date: July 17, 2000

to: [redacted], Appeals Officer, [redacted]

from: District Counsel, [redacted]

subject: [redacted] - [redacted] [redacted], [redacted]
De Minimis Rule for Capital Expenditures

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By memorandum dated February 25, 2000, our office was requested to be provide Field Service Advice on the following issues:

ISSUES PRESENTED

1. Should the Taxpayer be allowed to use a de minimis rule to determine the deductibility of capital expenditures for [redacted], [redacted], and [redacted]?

2. If the Taxpayer should be allowed to use a de minimis rule, is $3,000 an appropriate threshold?

3. What effect do the verbal agreements and/or "Letters of Understanding" entered into by the Taxpayer and Service have on the deductibility of capital expenditures with a cost of $3,000 or less for [redacted], [redacted] and [redacted]?

4. Has the District Director made, or authorized a Change in Method of Accounting for capital expenditure of items with a cost of $3,000 or less for the years [redacted], [redacted] and [redacted]?

5. How should the significant long-term benefit, as discussed in the <u>INDOPCO, Inc. v. Commissioner</u>, 92-1 U.S.T.C. ¶ 50,113

be interpreted in light of a $3,000 de minimis rule?

6. Do the decisions in Klutz v. Commissioner, 38 T.C.M. 724, and Challenge Mfg. Co. v. Commissioner, 37 T.C.M. (1962), acq., 1962-2 C.B. 4, apply to the Taxpayer since the Taxpayer has [redacted] operating expenses than the cited cases?

SHORT CONCLUSION

Our conclusions as to the specific questions presented are detailed below. However, based upon our review of the facts and applicable legal principles, we believe that the Taxpayer has the stronger argument for allowing the use of a de minimis rule for expensing capital expenditures.

FACTS PRESENTED

On [redacted] of [redacted] entered into a verbal agreement with Revenue Agent [redacted] of the Service allowing the Taxpayer to establish a procedure for expensing capital expenditures with a cost of $[redacted] or less. The Taxpayer has verified the existence of such an agreement to the Appeals Division by an internal memo dated [redacted] (Exhibit 1 attached to your request). From a review of the internal memo, it appears to modify a prior agreement to allow the Taxpayer to expense capital expenditures of $[redacted] or less.

Our reading of Exhibit 1 indicates that Revenue Agent [redacted] proposed an adjustment to capitalize the items contained in [redacted] - Capital Items $[redacted] to $[redacted]. However, this adjustment was not pursued and [redacted] decided to allow expensing of all otherwise capital items costing $[redacted] or less. Through these actions, the Service may be seen to have acquiesced in the Taxpayer's de minimis rule.

On [redacted], [redacted] Manager, Tax Audit Division representing [redacted] and [redacted], Dallas District, entered into a "Letter of Understanding." (Exhibit 2 attached to your request). The "Letter of Understanding" allows the Taxpayer to establish a revised procedure for expensing capital expenditures with a cost of $3,000 or less. From a review of the "Letter of Understanding" it appears to modify yet another prior agreement to allow the Taxpayer to expense capital expenditures of $[redacted] or less. Certain exceptions (primarily where the Taxpayer's accounting guide and § 263A required) were maintained. Effective date of the change was [redacted]; thereby making the agreement a retroactive change.

It appears that the Service has, through a series of verbal and/or written agreements, allowed the Taxpayer to employ a de minimis rule for expensing capital expenditures below an agreed upon threshold. Pursuant to this understanding, the Taxpayer deducted capital expenditures for [redacted], [redacted] and [redacted] as follows:

[redacted] - $[redacted]
[redacted] - [redacted]
[redacted] - [redacted]

Total $[redacted]

During the audit of the Taxpayer's [redacted], [redacted] and [redacted] tax years, the examiner determined that all prior agreements should be set aside and that the Taxpayer should be required to capitalize all capital expenditures including expenditures of $3,000 or less. Apparently, a reevaluation of the de minimis rule occurred because of the significant increase in the total amount of items subject to the rule for [redacted] and [redacted]. The increase in capital expenditures under the de minimis rule for [redacted] and [redacted] stems from the Taxpayer moving its headquarters from the [redacted] area to [redacted]. In calculating the $3,000 per capital item, the Taxpayer took its invoices and counted each item on an invoice separately to see if it would meet the de minimis criteria. Although, on average, each invoice was far in excess of $3,000, by "fracturing" the invoice into separate items, the de minimis rule could be applied to most of the items on an invoice. (Examination Division's Rebuttal to Protest, pages 2 and 3).

It is not known if the Taxpayer had used this "fracturing" methodology in the past in determining the items subject to the de minimis rule. It is also not known if the verbal/written agreements contemplated this method of determining whether a capital expenditure fell within the de minimis rule. It is not disputed, however, that expenditures subject to the de minimis rule were incurred in the ordinary course of the Taxpayer's business and there is no indication that the expenditures have been shifted from one year to another to create a larger deduction than would otherwise be warranted for tax purposes.

The Appeals Division has determined that some small portion of the amount in dispute may otherwise be deductible under § 162 as moving expenses or other various miscellaneous expenses. However, the overwhelming amount of the proposed adjustment falls within the $3,000 de minimis rule.

The Taxpayer contends that capital expenditures of $3,000 or less are deductible based on prior agreements and in particular the "Letter of Understanding" dated [redacted] The Taxpayer also cites Cincinnati, New Orleans and Texas Pacific Railway Company v. U.S., 70-1 U.S.T.C. ¶ 9344, where a taxpayer was allowed to use such a de minimis rule for the capitalization of expenditures. The Service acquiesced to this issue in AOD CC-1977-97, dated July 15, 1977 for pending railroad cases only. GCM 34959 announced that although the issue was lost and should be conceded:

> We believe, however, that if the expensing of "small items" does not produce a distortion of income, the Service should allow such practice even though taxpayers may use a minimum amount in excess of our recommended general amount of $100. (at page 1).

The GCM also suggested that a Revenue Ruling should be issued on the subject of whether items are deductible under a de minimis rule. However, such a ruling was never issued.

The Taxpayer has further maintained that the amount deducted under the de minimis rule is not significant in relation to the size of its assets, sales or net income in [redacted] (Protest, page 44). In this regard, the Taxpayer has compared the $3,000 per item, and not the total of the items, to the various measurements stated.

LEGAL ANALYSIS

General Principles

Capital expenditures are amounts paid or incurred to restore, add to the value of, or substantially prolong the useful life of property owned by the taxpayer, such as plant or equipment. Capital expenditures also include amounts expended to adapt property to a new or different use. However, amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures.[1]

Capital expenditures cannot be currently deducted from gross income, but must be recovered through depreciation, depletion or amortization. If the asset is not subject to depreciation, depletion or amortization, then such expenditures are recovered

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[1] I.R.C. § 263 and Treas. Reg. § 1.263(a)-1.

upon the sale of the property. Capital expenditures cannot be taken into account through inclusion in inventory costs or as a charge to capital accounts or basis any earlier than the tax year during which the amount is incurred.[2] Examples of capital expenditures include the acquisition, construction or erection costs of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the tax year.

1. ***Should the Taxpayer be allowed to use a de minimis rule to determine the deductibility of capital expenditures for [redacted], [redacted] and [redacted]?***

Neither the Code, regulations, nor administrative pronouncement specifically allows the current deduction of a capital expenditure.[3] Once determined as a capital item, capitalization is the norm, irrespective of the dollar amount, unless the Code specifically provides otherwise.[4] But, since capitalization is a timing issue, tax accounting principles must also be considered. Capitalization is not an "immutable" rule. Its application must be tempered to ensure that a taxpayer's return clearly reflects income. Please see item 6 below for our detailed analysis regarding how the tax accounting principles effect a decision in this matter.

2. ***If the Taxpayer should be allowed to use a de minimis rule, is $3,000 an appropriate threshold?***

In our response to question 1, we have specifically rejected any de minimis rule for expensing capital items based solely under § 263. Once found to be a capital expenditure, capitalization is the norm. Cost of the item is irrelevant to capitalization.

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[2] Treas. Reg. § 1.263(a)-1.

[3] Although no administrative guidance currently exists, the Treasury/IRS 2000 Business Plan contains an agenda item to define in what cases de minimis rules are appropriate in the capitalization context. <u>See</u> Tax Analysts, Doc. 2000-8725 and Doc. 2000-8759.

[4] See I.R.C. § 263(b) for a non-exhaustive list of exceptions to capitalization.

3. ***What effect do the verbal agreements and/or "Letters of Understanding" entered into by the Taxpayer and Service have on the deductibility of capital expenditures with a cost of $3,000 or less for [redacted], [redacted], and [redacted]?***

Verbal agreements and/or "Letters of Understanding" fall under the general umbrella of being "collateral agreements." A collateral agreement is defined as a statement secured from, and signed by or for, taxpayers or related parties to clarify, or obtain a commitment relative to, some matter other than the amount of assessment or overassesment involved but corollary to the case disposition.[5] Although not executed by the taxpayer, the agreements made in this case do represent a commitment to a matter other than the amount of the assessment but corollary to the case disposition (i.e., how the examination is to be conducted).

The law, as well as the Internal Revenue Manual[6], makes clear that collateral agreements are not statutorily authorized and constitute only administrative devices. Section 7121 (closing agreements) and section 7122 (compromises) are the sole statutory avenues to achieve a binding finality in an agreement between the Service and taxpayers. The verbal agreements and "Letters of Understanding" do not purport to be and do not contain the statutory elements necessary to make them either closing agreements or compromises.

Although not statutorily binding, the Taxpayer appears to argue that the Service's acquiescence in its prior treatment of de minimis capital expenditures now estops the Service from proposing an adjustment. Arguments of this nature usually revolve around questions of equitable estoppel, detrimental reliance or a duty of consistency.

Generally, the courts apply a three-prong test in evaluating whether the Service is bound by a duty of consistency towards taxpayers with respect to its characterization and tax treatment of the same or similar item in separate tax years:[7]

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[5] IRM, Handbook No. 8(13)(10), Closing Agreement Handbook, Sub-Section 123(1), Collateral Agreements Distinguished.

[6] Ibid., at 123(4)

[7] The majority of this analysis comes from FSA 200009016 (November 30, 1999). Although it can not be cited as precedent, its rationale does show the thought process of the National Office on this issue.

1. The Service has made a representation of fact in a prior year;

2. The taxpayer has relied on the Service's representation for that year; and

3. The Service is seeking to change its representation made in the prior year on which the Taxpayer has relied.[8]

While this three-prong test is not specifically referred to by the courts in all estoppel cases, its elements are generally applied to one degree or another. The three elements taken together, have the most relevance in cases where the Service has made administrative determinations in accordance with the scope of its fact gathering role in applying the law.

The first prong requires that the Service make a representation of fact to the taxpayer in a prior year. In the case at hand, the examining agents did not determine the nature of, or impose the classification of, the capital expenditures on the Taxpayer. Rather, Revenue Agent [redacted] initially sought to change the manner in which the Taxpayer reported the capital expenditures on its tax return, after the Taxpayer had already determined that they were capital expenditures. His subsequent agreement had the effect of allowing the Taxpayer to maintain its manner of reporting the capital expenditures and thereby preserving the Taxpayer's classification. Since the Service did not represent or determine any fact regarding the capital expenditures, but instead allowed the Taxpayer to maintain its classification of them, this first prong of the test is not meet.

The second prong requires that the taxpayer rely on the Service's prior year representation of fact. The Taxpayer argues that the Service's failure to adjust the tax treatment of the capital expenditures over the previous examination cycles coupled with the oral agreements and "Letters of Understanding" is tantamount to an acquiescence on which the Taxpayer may reasonably rely.[9] But the Taxpayer has not shown that it in fact relied on the Service's prior treatment or communication in entering into the capital expenditures. In those cases where

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[8] Johnston v. United States, 605 F. Supp. 26 (D. Mt. 1984); Massaglia v. Commissioner, 312 F.2d 311 (9th Cir. 1962); Conway Import Co., Inc. v. United States, 311 F. Supp. 5 (E.D.N.Y. 1969); Schuster v. Commissioner, 312 F.2d 311 (9th Cir. 1962) and Williamette Valley Lumber Co. v. United States, 252 F. Supp 199 (D. Ore. 1966)

[9] Protest, page 38.

estoppel was found against the Service, all involved situations where the Service imposed either a tax characterization, an accounting method, or an administrative requirement on the taxpayer, each of which had tax consequences less favorable than the one of the taxpayer's own choosing.[10] Under those circumstances, the courts determined that a taxpayer's reliance on government imposed requirements could be inferred where the taxpayer would not have selected the treatment for itself.

In this case, the Service did not impose the de minimis rule upon the Taxpayer. Furthermore, no corresponding detriment inured to the Taxpayer when the Service accepted a de minimis rule as found in the Taxpayer's books and records.

The third prong of the duty of consistency test requires the Service change in a later year the representation it made to the taxpayer in an earlier year, after the taxpayer has already relied on the earlier representation. As discussed above, absent any showing that the Taxpayer actually relied on the Service's treatment in prior exam cycles as a precondition for entering into the transactions relevant to the current cycle, the duty of consistency doctrine does not estop the Service from exercising its discretion to characterize the transactions as capitalization expenditures under § 263.

The Taxpayer's interpretation of the oral agreements and "Letters of Understanding" as consisting an estoppel against the Service would prevent the Commissioner from ever exercising its discretion over the Taxpayer with respect to de minimis capital expenditures. In effect, the Taxpayer demands continuing special treatment that is not available to the tax community at large.[11] Even if a pattern of clear acquiescence exists with respect to the characterization of the de minimis capital expenditures, the Taxpayer's estoppel argument does not defeat the Service's right to (1) determine the factual similarity between the present and past transactions;[12] (2) require proof that the Taxpayer relied

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[10] Johnston, Massaglia, Conway Import Co., Schuster and Williamette, Ibid.

[11] In its protest, the Taxpayer alleges that other CEP taxpayers have similar arrangements with other audit teams. (Protest, page 43). However, given no statutory or regulatory authority for the de minimis capital expenditure rule, a taxpayer may not rely upon the anecdotal treatment of other taxpayers to justify claiming a deduction.

[12] Hospital Corporation of America v. Commissioner, T.C. Memo 1996-105 at 62, 65.

on the Service's prior determination as a precondition for entering into the capital expenditures for the current years[13]; or (3) serve notice on the Taxpayer that it will no longer administratively follow the selective treatment singularly accorded it in prior examinations.[14]

We conclude that the Service is not estopped from correcting its prior allowance of the de minimis capital expenditures. The Service did not impose the methodology on the Taxpayer who has shown no detrimental consequences from the prior allowances in the current examination cycle.

4. Has the District Director made, or authorized a Change in Method of Accounting for capital expenditure of items with a cost of $3,000 or less for the years [redacted], [redacted] and [redacted]?

The phrases "method of accounting" or "change in method of accounting" are not defined by either the Internal Revenue Code or Treasury Regulations. However, guidance as to whether a particular change in reporting amounts to a change in method of accounting is provided by applicable treasury regulations[15]:

> A change in method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. ... A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction.

By adjusting the Taxpayer's treatment of de minimis capital expenditures, the Service is changing its method of accounting of a material item. Under its present method of tax accounting, the Taxpayer is taking a current deduction for its de minimis capital expenditures. From the oral agreements and "Letters of Understanding," it appears that this tax method of accounting has been used by the Taxpayer consistently for many years. The proposed method of accounting requires capitalization and depreciation of those expenditures over their applicable recovery period. As such the timing of the deduction is in controversy,

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[13] Johnston, supra. and Schuster, supra.

[14] Williamette Valley Lumber Co. supra.; Conway Import Co., Inc., supra.

[15] Treas. Reg. § 1.446-1(e)(2)(ii) (A) and (B).

and is a change in the accounting treatment of the item.[16]

Although a change in accounting treatment for an item is a necessary condition to find that a change in accounting method has occurred, it, alone, is not a sufficient condition. The item changed must also be "material." The regulations are specific in defining a "material" item to be any item which involves the proper time for the taking of a deduction.[17] Since the change from currently deducting an item to capitalizing and depreciating it is a matter of the proper time to take a deduction, it is, by regulation, material.

Although the courts have agreed that only changes in material items are involved in a change in method of accounting, they have not always agreed with the materiality definition found in the regulations. Their rationale is very simple: if a change in the method of accounting for an item is defined as a timing difference, and all material items are defined as timing differences, then all items are material. Essentially, the regulation definition of material renders the requirement of only changes in material items as being changes in method of accounting redundant.

Instead the courts have struggled with the regulation definition as well as the ordinary meaning of the word "material" when the issue of materiality have been raised. In the latter instance, the courts have looked at the term in both its relative and absolute sense.[18] Little can be gained from an analysis of these cases other than materially is determined on a case-by-case basis.

In the [redacted] letter, the Service agreed that the Taxpayer would be allowed to currently deduct capital expenditures of $3,000 or less as was currently being done in the Taxpayer's books and records. We believe the reason for this agreement is that neither the Taxpayer nor the Service believed that in either a relative or absolute sense the dollar amounts

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[16] See Rev. Proc. 92-20, 1992-1 C.B. 685, § 2.01; Knight-Ridder Newspapers, Inc. v. United States, 743 F.2d 781 (11th Cir. 1984).

[17] Treas. Reg. § 1.446-1(e)(2)(A).

[18] See Southern Pacific Transportation Co. v. Commissioner, 75 T.C. 497 (1990); Cincinnati, New Orleans, and Texas Pacific Railway Co. v. United States, 424 F.2d 563 (Ct. Cl. 1970); and Baltimore and Ohio Railroad Co. v. United States, 603 F.2d 165 (Ct. Cl. 1979).

involved for these capital expenditures was material. From the Service's point of view, as required by the regulation, a change in method of accounting did occur as the timing treatment of a material item was changed. From the Taxpayer's point of view, and probably some courts, a change in method of accounting did not occur because the item changed was not material.

Should this case be litigated, the Service will defend the interpretation of the regulation. However, it must be acknowledged that if the Taxpayer's assertion regarding the materiality of the change is correct, a hazard of litigation exists for the government.

At trial, the Taxpayer must establish that the Service abused its discretion by requiring the change which is the applicable standard whenever the Service initiates a change in method of accounting under § 446(b).[19] To satisfy that heavy burden, the Taxpayer must show that the Service's adjustment was clearly unlawful or plainly arbitrary.[20] As explained under issue 6, a colorable argument can be made by the Taxpayer that the de minimis rule does clearly reflect its income and is a proper tax method of accounting. As such, a court could find an abuse of discretion upon the part of the Service for initiating the change in the Taxpayer's method of accounting.

5. ***How should the significant long-term benefit, as discussed in the <u>INDOPCO, Inc. v. Commissioner</u>, 92-1 U.S.T.C. ¶ 50,113 be interpreted in light of a $3,000 de minimis rule?***

In <u>INDOPCO, Inc. v. Commissioner</u>, 503 U.S. 79 (1992), the Supreme Court set forth its most recent elucidation on the subject of capitalization. The taxpayer was a public corporation whose two largest shareholders were approached in October 1977 about selling their stock in a friendly takeover transaction. The shareholders indicated that they would part with their stock if a transaction was structured under which they could do so tax-free. A tax-free acquisition plan was formulated under which the shareholders could transfer their stock to the acquirer. Shortly thereafter, the taxpayer's board of directors retained an investment banking firm to evaluate the formal offer for the stock, render a fairness opinion, and generally assist in the

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[19] <u>Prabel v. Commissioner</u>, 91 T.C. 1101, 1112 (1988), <u>aff'd</u>. 882 F.2d 820 (3rd. Cir. 1989).

[20] <u>Thor Power Tool Co. v. Commissioner</u>, 439 U.S. 522, 532-533 (1979).

event of the emergence of a hostile tender offer. The transaction was consummated in August 1978. The taxpayer deducted on its Federal income tax return the costs associated with the acquisition as an ordinary and necessary business expense.

The Commissioner determined that § 162(a) did not let the taxpayer deduct the direct costs that it incurred to facilitate the transaction: (1) investment banking fees and expenses; (2) legal fees and expenses related to advice given to the taxpayer and its board on their legal rights and obligations with respect to the transaction; and (3) the participation in negotiations, the preparation of documents, and the preparation of a request for a ruling from the Commissioner on the tax-free acquisition plan. Rather the enumerated expenses had to be capitalized since they provided a new capital structure for the taxpayer with significant future benefits.

The United States Tax Court held for the Commissioner and found that it was in the taxpayer's long-term interest to shift ownership of its stock to the acquirer.[21] The Tax Court stated that the expenses were capitalizable because they were incurred incident to a shift in ownership benefits "which could be expected to produce returns for many years in the future."[22]

The Tax Court's holding was affirmed by the United States Court of Appeals for the Third Circuit, which rejected the taxpayer's argument, based on Lincoln Savings & Loan Association v. Commissioner,[23] that the expenses were not capitalizable because they did not create or enhance a separate and distinct asset.[24] The Supreme Court also rejected this argument. The Court stated that Lincoln Savings stands merely for the proposition that an expense must be capitalized under § 263(a)(1) when it serves to create or enhance a separate and distinct asset. The

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[21] National Starch & Chem. Corp. v. Commissioner, 93 T.C. 67 (1989), aff'd. 918 F.2d 426 (3d Cir. 1990), aff'd. sub nom. INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992).

[22] Ibid. at 75 (quoting E.I. du Pont de Nemours & Co. v. United States, 432 F.2d 1052, 1059 (3d Cir. 1970)).

[23] 403 U.S. 345 (1971), rev'g. 422 F.2d 98 (1970), rev'g. 51 T.C. 82 (1968).

[24] Ibid., at 354.

Court noted, however, that the creation or enhancement of a separate asset is not the sole determinant for capitalization. The Court clarified its holding in Lincoln Savings, stating:

> Nor does our statement in Lincoln Savings that "the presence of an ensuing benefit that may have some future aspect is not controlling" prohibit reliance on future benefit as a means of distinguishing an ordinary business expense from a capital expenditure. Although the mere presence of an incidental future benefit -- "SOME future aspect" -- may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization. Indeed, the text of the Code's capitalization provision, § 263(a)(1), which refers to "permanent improvements or betterments," itself envisions an inquiry into the duration and extent of the benefits realized by the taxpayer.[25]

The Court concluded that the professional fees before them fell within the longstanding rule that expenses directly incurred in reorganizing or restructuring a corporate entity for the benefit of future operations are not deductible under § 162(a). The purpose for which these expenses are made, the Court stated, "has to do with the corporation's operations and betterment * * * for the duration of its existence or for the indefinite future or for a time somewhat longer than the current taxable year."[26]

Many have attributed INDOPCO with creating a new standard for capitalization of expenditures. The Service has maintained a consistent position that INDOPCO merely affirms those tests and standards previously enunciated by the courts with respect to capitalization.[27]

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[25] INDOPCO, supra. at 87-88; fn. ref. and citations omitted.

[26] Ibid. at 90 (quoting General Bancshares Corp. v. Commissioner, 326 F.2d 712, 715 (8th Cir. 1964), aff'g. 39 T.C. 423 (1962).

[27] See Rev. Rul. 96-92, 1996-2 C.B. 9 (training costs); Rev. Rul. 98-25, 1998-1 C.B. 998 (environmental clean-up costs); Rev. Rul. 94-12, 1994-1 C.B. 36 (repairs); Rev. Rul. 94-77, 1994-2 C.B. 19 (sickness and disability payments); Rev. Rul. 92-80, 1992-2 C.B. 57 (advertising); Rev. Rul. 99-23, 1999-1 C.B. 32 (business start-up costs); Rev. Rul. 2000-4, 2000-4 I.R.B. 331 (ISO 9000 certification costs); PLR 9043003 and PLR 9043004 (hostile takeover costs).

One of the pre-INDOPCO tests for capitalization was ennunicated in Lincoln Savings as clarified by INDOPCO. As stated above, Lincoln Savings stands for the proposition that an expense must be capitalized under § 263(a)(1) when it serves to create or enhance a separate and distinct asset.

Here, there seems little doubt that the majority of the de minimis capital expenditures are for items which create a separate and distinct asset which has a useful life beyond the taxable year (i.e., furniture, fixtures, computers, etc.) The long-term benefit conferred by these assets require depreciation of the assets no matter their cost. As such, tax accounting considerations aside, capitalization of these expenditures are required irrespective of the INDOPCO decision.

6. Do the decisions in Klutz v. Commissioner, 38 T.C.M. 724, and Challenge Mfg. Co. v. Commissioner, 37 T.C.M. (1962), acq., 1962-2 C.B. 4, apply to the Taxpayer since the Taxpayer has [redacted] operating expenses than the cited cases?

In Challenge Manufacturing Company v. Commissioner, 37 T.C. 650 (1962), the taxpayer sought to currently deduct the purchase price of stereo viewers supplied to its salesman. The Service disallowed the deduction on the grounds that the stereo viewers constituted a capital expenditure.

In sustaining the Service's determination, the Court stated:

> ... It would seem that in view of the probable borderline character of this item and its comparatively small amount it would have been the wiser audit practice to have accepted the taxpayer's treatment, particularly, since in the long run, the revenues would not be adversely affected. Nevertheless, the matter has been placed in issue, and we are called upon to decide it. However, there is no evidence in the record from which we can determine the useful life of these stereo viewers, and, since the burden of proof is upon the taxpayer, we must decide this issue against it for failure of proof.

As it stated, the Court found the issue to be one of burden of proof rather than a decision on the merits of the capitalization issue. As such, the Court's comments as to the "wiser audit practice" become dicta for future cases on the same issue. Because it is dicta, we do not believe that the Challenge Manufacturing decision can be cited as precedent either for or against a decision in this case.

In Klutz v. Commissioner, T.C. Memo 1979-169, the taxpayer sought to currently deduct a used adding machine. The taxpayer took the position that since its cost was "relatively small," it did not need to be depreciated but rather its cost could be deducted in the year of acquisition.

Although the Court characterized the entire case as one dealing with a lack of substantiation on the taxpayer's part, the Court did analyze the need to capital the adding machine:

> ... While it may well be appropriate in certain instances for taxpayers to deduct, in the year of acquisition, the cost of assets having a useful life in excess of one year, Cincinnati, New Orleans and Texas Pacific Railway Co. v. United States [citation omitted], we do not believe this case constitutes such an instance. In those cases in which the deductibility of assets admittedly having a useful life in excess of one year is discussed, the relative size of the expenditure is only one factor taken into account for purposes of determining whether the assets may be currently deducted. Cincinnati, New Orleans and Texas Pacific Railway Co., supra. See also Manger Hotel Corporation v. Commissioner, [citation omitted]; Libby & Blouin, Ltd. v. Commissioner, [citation omitted][28]. Considering the facts in the case before us, we believe the cost of acquiring the adding machine should properly have been capitalized.

While acknowledging relative size as a factor, the Court never did say how this factor is utilized in the capitalization decision. Because of this lack of analysis, it is impossible to say what final role relative size played in the Court's determination. However, the cases cited by the Court do provide a basis for further analysis.

In Manger Hotel Corporation v. Commissioner, 10 T.C. 520

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[28] Our review of this decision shows it concerned with replacements or repairs of capital items. As such, it has little value in the present analysis. Libby & Blouin, Ltd. v. Commissioner, 4 B.T.A. 910 (1926).

(1948), the taxpayer sought to deduct equipment as a necessary expense of carrying on its business. The Service disallowed the expense since the equipment had a life of substantially more than one.year. The equipment cost was capitalized and depreciated allowed on it.

The Court made much of the "meager" record before it and upheld the Commissioner's determination in the absence of proof that the items such be expensed rather than capitalized. Although dicta, the Court did specifically state what factors should be considered in the capitalization decision:

> ... If the record showed that these expenditures were [for new equipment rather than replacement of old equipment], similar expenditures in substantially the same amount had been made year after year since the petitioner began operating under the lease, none of which had been capitalized, such items had relatively short lives in the hotel, and the petitioner might expect to have to make similar expenditures in subsequent years, then it might appear that the Commissioner erred in failing to allow a deduction under some provision of the Internal Revenue Code for such expenditures for the taxable year. ...

From the Court's language, it can be inferred that consistency in accounting for similar recurring expenditures by the taxpayer is a key consideration in determining whether capitalization is always required. In the present instance, although the de minimis amount fluctuated, the Taxpayer did maintain a consistent accounting policy of deducting small capital expenditures.

Of greater importance is the Court's reliance upon Cincinnati, New Orleans and Texas Pacific Railway Co. v. United States, 424 F.2d 563 (Ct. Cl. 1970). This case is discussed in depth in the Taxpayer's protest.[29] Here the Claims Court held that the taxpayer's policy of expensing capital items costing $500 or less was an acceptable method of tax accounting as it clearly reflected the taxpayer's income.

We believe that Cincinnati, New Orleans and Texas Pacific Railway Co. still has validity today. GCM 34959 (July 25, 1972), which was issued regarding this case, found the Claims Court's

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[29] Protest, pages 40 -44.

reasoning compelling for several reasons. First, §§ 263 and 446 are inextricably intertwined. Although § 263 may dictate capitalization of certain expenses, it cannot be read in isolation. Second, § 446(b) requires that a taxpayer's method of tax accounting must "clearly reflect its income." So long as the method of capitalized is not specifically prohibited and does not lead to a distort of a clear reflection of income, it is permissible under the Code.[30]

Where a taxpayer demonstrates that the taxpayer's method of accounting clearly reflects income, the Service cannot require the taxpayer to change to a different method even if, in the Service's view, its method more clearly reflects income.[31] Whether the particular accounting method clearly reflects income is a question of fact.[32] If the taxpayer's method of accounting is explicitly authorized by the Internal Revenue Code or by the regulations, the Service may not reject that method as not providing a clear reflection of income if the taxpayer has applied that method on a consistent basis.[33] Also, if that method of accounting reflects a consistent application of generally accepted accounting principles, it will ordinarily be regarded as clearly reflecting income.[34]

GCM 34959 cites to numerous financial accounting authorities to demonstrate that generally accepted accounting practice allows the expensing of small capital items.[35] Although this is just one factor in determining clear reflection of income under § 446(b), it is often a critical one. As stated in the GCM:

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[30] Should a regulation ever be issued regarding the expensing of de minimis capital items, the advice contained in this memorandum would certainly change.

[31] Molsen v. Commissioner, 85 T.C. 485, 489 (1985).

[32] Coors v. Commissioner, 60 T.C. 368, 394 (1973), aff'd., 519 F.2d 1280 (10th Cir. 1975).

[33] Hallmark Cards, Inc. v. Commissioner, 90 T.C. 26, 31 (1988).

[34] Hallmark Cards, supra. at 31; Treas. Reg. § 1.446-1(a)(2); But see Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 539-540 (1979)

[35] GCM 34959, pages 4 and 5.

> We believe that the Service is not inalterably bound to abide by a strict capitalization rule when dealing with minor, recurring-type small items. It is clearly within the Commissioner's discretion under section 446(b) to allow expensing of such items as long as income is clearly reflected under such method. ...[36]

But for the increase in the total amount of the de minimus capital expenditures, we believe that Cincinnati, New Orleans and Texas Pacific Railway Co. is clearly on point and would allow the expensing of the capital items. Although the increase in [redacted] and [redacted] is substantial, in comparison to [redacted], we cannot say that it is not warranted as a legitimate business expenditure for the years at issue.

We do not believe that the accounting methodology as previously allowed by the Examination Division was specific as to whether an invoice could be "fractured" into its components to meet the de minimus rule. However, we do not feel that this "fracturing" is inconsistent with previous year's methodology if only capital items of $3,000 or less were allowed to be expensed in those years. In other words, if the invoices for [redacted], [redacted] and [redacted] contain items meeting the de minimus rule, the fact that the invoice as a whole is greater than $3,000 is irrelevant. Capitalization would only be required of each individual item and not for an entire invoice.

CONCLUSION

Our analysis of the law and facts for this issue supports the current deduction of capital items when to do so would clearly reflect the Taxpayer's income under its tax accounting method. Previous audits of the Taxpayer have allowed use of the de minimus rule because no distortion of the clear reflection of income principle was perceived to exist. Although the expenditures subject to the de minimus rule have significantly grown in the years pending before the Appeals Division, this growth seems to have occurred due to legitimate business purposes and is not a concerted effort of tax manipulation on the part of the Taxpayer. We believe that the Taxpayer has the stronger argument for expensing the capital items at issue.

This document is subject to the Large Case Coordination

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[36] Ibid., page 6

Procedures of CCDM 35(19)4(4). Pursuant to this provision, a copy of this advice has been forwarded to the Assistant Chief Counsel for his review concurrent with the providing of this advice to you. Within ten days of receipt, the appropriate Associate Chief Counsel is required to respond regarding the advice. The response will indicate whether the National Office: (a) concurs with the Field advice; (b) believes some modification of the advice is appropriate; or (c) needs additional information or time for analysis in order to evaluate the advice. Our office will inform you of the comments received by us.

Our office will maintain its file on this case pending notification from you that it may be closed. If you should have any questions regarding this memorandum, please contact the undersigned at [redacted].

[redacted]
District Counsel
[redacted]

By: [redacted]
Attorney